Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
In the Matter of Petition of WorldCom, Inc.	)	
Pursuant to Section 252(e)(5) of the	)	CC Docket No. 00-218
Communications Act for Preemption	)	
of the Jurisdiction of the Virginia State	)	
Corporation Commission Regarding	)	
Interconnection Disputes with	)	
Verizon Virginia Inc., and for	)	
Expedited Arbitration	)	
	)	
In the Matter of Petition of AT&T	)	
Communications of Virginia, Inc.,	)	CC Docket No. 00-251
Pursuant to Section 252(e)(5) of the	)	
Communications Act for Preemption	)	
of the Jurisdiction of the Virginia State	)	
Corporation Commission Regarding	)	
Interconnection Disputes with	)	
Verizon Virginia Inc., and for	)	
Expedited Arbitration	)	

VERIZON VIRGINIA INC.'S OPPOSITION TO AT&T/WORLDCOM'S APPLICATIONS FOR REVIEW

(Public Version)

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SUMMARY AND INTRODUCTION

The modifications that AT&T/WorldCom seek in their applications for review are contrary to Commission precedent and unsupported by the record. The reductions they seek in the loop rates adopted in the *Order*[1/] would create additional subsidies for CLECs that rely on UNEs and dampen even further the prospects for facilities-based competition in Virginia.

The loop rates about which the CLECs complain and which they insist must be drastically reduced are only marginally higher than the previous Virginia statewide average rate, and are still below the New York benchmark. Further, the CLECs seek these reductions even though the *Order* produces the lowest switching rates in effect in any of the 31 jurisdictions where Verizon provides service and produces a UNE-P rate in zone 1 that is the *second lowest* in any Verizon jurisdiction for any comparable zone. And the *Order* reduces the high capacity loop rates by as much as fifty percent The *Order* makes all these reductions even though the current rates *already* are equal to, and in the case of the so-called UNE-P, *lower* than, the corresponding rates in New York — a state that itself has applied TELRIC aggressively.

Indeed, as Verizon VA showed in its application for review, the loop rates that AT&T and WorldCom seek to reduce are already below cost. They were set using a modified version of the universal service model that the Commission has acknowledged cannot reliably measure UNE loop costs. And they are based on a number of unrealistic input assumptions that are at odds with Commission precedent.

1/ *See* Memorandum Opinion and Order, *Petitions of WorldCom, Inc. and AT&T Comm. of Virginia Inc. Pursuant to Section 252(e)(5) of the Communications Act for Preemption of the Jurisdiction of the Virginia State Corporation Commission Regarding Interconnection Disputes with Verizon Virginia Inc., and for Expedited Arbitration*, CC Docket Nos. 00-218, 00-251 (rel Aug 29, 2003) ("*Order*").

AT&T/WorldCom first insist that the Commission should recant its recent clarification in the *Triennial Review Order*[2/] and adopt a cost of capital that reflects a monopoly environment. But the Commission's *Triennial Review Order* properly recognized that the cost of capital must reflect the risks associated with a competitive market. Indeed, AT&T/WorldCom's own expert in this case expressly conceded the need for such consistent assumptions. AT&T/WorldCom's remaining challenges to the *Order*'s cost of capital inputs are unsupported by the record and are contradicted by the evidence and data supplied by the CLECs themselves.

Next, AT&T/WorldCom contend that the Commission should reduce basic loop rates to account for shared structure costs that they assert are recovered through *high capacity* loop rates. But what their argument really shows is that the Bureau should not have used the CLECs' modified version of the universal service model in the first place. The CLECs argue that, because their own model cannot accurately allocate shared structure costs between basic and high capacity loops, the Commission should *assume* that some shared structure costs are included in the high capacity loop rates the *Order* adopts, and therefore the Commission should reduce basic loop rates. But neither the CLECs' model nor any evidence in the record supports their assertion that the high capacity loop rates recover *any* structure costs. To the contrary, the *Order* sets high capacity loop rates using unsupported, non-cost based ratios, and does not try to identify specific costs that allegedly are recovered by those rates. AT&T/WorldCom's arguments therefore demonstrate that the Bureau should have adopted Verizon VA's models,

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2/ *See* Report and Order and Order on Remand and Further Notice of Proposed Rulemaking, *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, CC Docket Nos. 01-338, 96-98, 98-147, FCC 03-36 (rel. Aug. 21, 2003) ("*Triennial Review Order*").

which were the only ones in the record capable of properly accounting for the costs of both basic and high capacity loops.

Finally, AT&T contends that the Commission should reduce loop rates to remove "broadband-related costs" that it claims are no longer appropriate as a result of changes the *Triennial Review Order* made with respect to certain loop unbundling obligations. But neither the models proposed by the parties nor the rates set by the Bureau include any such costs to begin with. The CLECs' modified universal service model, on which the loop rates are based, was specifically designed to model only basic, narrowband loop costs. Thus, the evidence in the record actually demonstrates that no adjustment in loop rates would be necessary to reflect the Commission's new unbundling rules. In any event, whether any adjustment in the pricing rules is appropriate as a result of the Commission's loop unbundling decisions in the *Triennial Review Order* is a question the Commission has specifically raised in the *TELRIC NPRM*,[3/] and it would be inappropriate to attempt to prejudge it here.

Thus, there is no basis for the adjustments that AT&T/WorldCom demand. The Commission should reject AT&T/WorldCom's arguments, and should instead make the adjustments described in Verizon VA's application for review.

I. AT&T/WORLDCOM'S APPLICATIONS FOR REVIEW OF THE ORDER'S COST OF CAPITAL SHOULD BE DENIED.

Rather than being an "extraordinarily high value" as AT&T and WorldCom claim, AT&T AFR at 3; WorldCom AFR at 3, the 12.95% cost of capital adopted by the *Order* is *lower* than AT&T's and WorldCom's own cost of capital figures for evaluating investments. As the

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3/ Notice of Proposed Rulemaking, *Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers*, WC Docket No. 03-173, FCC 03-224 (rel. Sept. 15, 2003) ("*TELRIC NPRM*").

Bureau recognized, AT&T has used a cost of capital of 15.31% for general investment purposes. *See Order* ¶ 92 n.268. Further, the cost of capital AT&T uses for evaluating local exchange investments also is **[BEGIN AT&T PROPRIETARY]** XXXXXXXXXXXXXXXX **[END AT&T PROPRIETARY]**, as is the corresponding figure for WorldCom, at **[BEGIN WORLDCOM PROPRIETARY]** XXX **[END WORLDCOM PROPRIETARY]**. *See* AT&T Response to Staff Record Request No 10 (Oct. 24, 2001); WorldCom Response to Staff Record Request No. 10 (Oct. 24, 2001). While AT&T/WorldCom note that the figure adopted in the *Order* is above the costs of capital adopted by some other state commissions, those costs of capital were set prior to the Commission's clarification in the *Triennial Review Order* that the TELRIC cost of capital must reflect the risks of a competitive market and were improperly based on the CLECs' arguments that it was permissible to base a cost of capital on a monopoly assumption even while assuming a competitive market for setting other inputs.

While the CLECs' own costs of capital are *higher* than the figure adopted in the *Order*, their costs of capital obviously do not reflect the additional risks inherent in the unbundling regime. As the Commission has made clear, the TELRIC cost of capital must reflect all the added "risks associated with the regulatory regime to which a firm [providing UNEs] is subject."[4/] As Verizon VA explained in its application for review, the cost of capital adopted by the *Order* is too low because it fails to account fully for relevant regulatory risks.[5/] In particular,

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[4/] Reply Brief for Petitioners United States and the FCC, *Verizon Communications, Inc. v. FCC*, Nos 00-511 *et al.*, at 12 n.8 (July 2001) ("FCC Reply Br.").

[5/] *See, e.g.*, Verizon Virginia Inc. Direct Testimony of Dr. Howard Shelanski at 13-14 (July 31, 2001) ("VZ-VA Ex. 101"); Verizon Virginia Inc. Direct Testimony of Dr. James Vander Weide at 5, 41 (July 31, 2001) ("VZ-VA Ex. 104"); Verizon Virginia Inc. Rebuttal Testimony of Dr. James Vander Weide at 30-31 (Aug. 27, 2001) ("VZ-VA Ex. 112"); Verizon Virginia Inc. Surrebuttal Testimony of Dr. James Vander Weide at 11, 21 (Sept. 21, 2001) ("VZ-VA Ex.

the risks of providing UNEs are similar to the risks inherent in cancelable operating leases, where the lessees may opt to cancel and the lessor bears the risk that the asset will sit idle or that rates may decrease. This is the same risk that causes vendors to charge substantially more to rent a computer on a weekly or monthly basis compared to the proportionate cost of buying the computer or entering into a long term lease. And this risk is in addition to the normal risks of a competitive market. Verizon VA submitted evidence demonstrating that a risk premium of 5.41% should be added to the weighted average cost of capital to account for some of the regulatory risks Verizon VA faces in providing UNEs. *See* VZ-VA AFR at 51. The 12.95% cost of capital adopted by the *Order* wholly fails to account for those risks. In any event, AT&T/WorldCom's arguments as to why the cost of capital should be reduced should be rejected.

A. The *Order* Correctly Bases the Cost of Capital on the Assumption of a Competitive Market.

Despite the Commission's recent clarification in the *Triennial Review Order* that a TELRIC cost of capital must be based on a competitive market, AT&T/WorldCom argue that the *Order*'s assumption of a competitive market for purposes of calculating the cost of capital was flawed and that the Bureau should have ignored the Commission's direction. *See* AT&T AFR at 4-6; WorldCom AFR at 4. But the Bureau, acting in place of the Virginia commission, was obligated to follow the Commission's clarification of its own rules.[6/] Indeed, even AT&T admits

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118"); Verizon Virginia Inc. Rebuttal Testimony of Dr. Jerry Hausman at 3-4 (Aug. 27, 2001) ("VZ-VA Ex. 111").

6/ *See Verizon Communications Inc. v. FCC*, 535 U.S. 467, 494 (2002) (Commission pricing methodology "bind[s] state ratemaking commissions"); *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 384-85 (1999); *MCI Telecomm. Corp. v. Bell Atlantic-Pa.*, 271 F.3d 491, 516 (3d Cir. 2001) (state commissions have no authority to deviate from FCC regulations and any state commission determination that is inconsistent with FCC regulations must be struck down), *cert.*

as much, noting that "[t]he Bureau understandably . . . tried to follow" the Commission's *Triennial Review Order* clarification. AT&T AFR at 4.

In any event, the Commission's clarification unquestionably was correct. As it explained, because "[t]he objective of TELRIC is to establish a price that replicates the price that would exist in a market in which there is facilities-based competition," the TELRIC cost of capital should "reflect the competitive risks associated with participating in such a market." *Triennial Review Order* ¶¶ 680-81. The Commission specifically rejected the same argument that AT&T repeats in its AFR — that "paragraph 702 of the *Local Competition Order* requires consideration of the *actual* competitive risks an incumbent LEC faces, not the risks it would face in the competitive market that TELRIC assumes." *Id.* ¶ 679 (emphasis in original).[7/] As the Commission explained,

> We do not agree with AT&T that paragraph 702 of the Local Competition Order limits a state to considering only the actual competitive risk the incumbent LEC currently faces in providing UNEs. . . . The Commission specifically recognized that increased competition would lead to increased risk, which would warrant an increased cost of capital. Although paragraph 702 states that there was limited competition for network elements at the time, it is clear from our discussion of the TELRIC methodology that future competition must be considered in assessing risk.

Id. ¶ 681.

AT&T fares no better in claiming that the Bureau somehow impermissibly "updat[ed] the record" by taking into account the Commission's discussion in the *Triennial Review Order.* AT&T AFR at 12-13. The Commission's clarification in the *Triennial Review Order* was not a

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denied sub nom. Pennsylvania Pub. Util. Comm'n v MCI Telecomm. Corp., 537 U.S. 941 (2002).

7/ *See also* AT&T AFR at 4 (citing First Report and Order, *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, 11 FCC Rcd 15499, 15856 ¶ 702 (1996) ("*Local Competition Order*")).

new piece of factual evidence or a novel legal argument proposed by a party after the record had closed; rather, it was a clarification of existing rules that the Bureau was bound to follow. As the Commission observed, it "specifically recognized [in the *Local Competition Order*] that increased competition would lead to increased risk, which would warrant an increased cost of capital. . . . [I]t is clear from our discussion of the TELRIC methodology [in the *Local Competition Order*] that future competition must be considered in assessing risk." *Triennial Review Order* ¶ 681.

Moreover, the record in this case compelled the adoption of a cost of capital that reflected the risks of a competitive market. AT&T/WorldCom's own economic witness expressly conceded at the hearings that the TELRIC cost of capital used in UNE studies must assume a fully competitive market. As she acknowledged: "I think all the model's assumptions have to be consistent. So, to the degree that it requires a competitive market to get all of the other assumptions, that would be true for the cost of capital as well." Tr. at 3202 (Murray). And Verizon VA submitted extensive testimony by Dr Shelanski and Dr. Vander Weide demonstrating that a cost model that does not consistently reflect the competitive market assumption, including in the cost of capital, simply will not produce rates that reflect the costs that competitors would face in a competitive market.[8/]

AT&T/WorldCom's remaining arguments are easily dismissed. *First,* they claim that, while "costs" should be based on a competitive market, the "returns" need not be. AT&T AFR

8/ *See* VZ-VA Ex. 104 at 8, 25-30; Tr. at 3475-82, 3525, 3529-30, 3548, 3562-63, 3568-69; VZ-VA Ex. 112 at 2-4, 6-7, 14, 16-18, 20, 24, 39-40; VZ-VA Ex. 118 at 8-9, 12-18 (demonstrating that the *Local Competition Order,* subsequent FCC orders, the FCC Reply Brief, and general economic principles require consistent competitive market assumptions); Surrebuttal Testimony of Drs. Howard Shelanski and Timothy Tardiff at 14 n.13, 16-17 (Sept. 21, 2001) ("VZ-VA Ex. 117").

at 5; WorldCom AFR at 4-5. Apparently, AT&T/WorldCom suggest that the "*cost* of capital" is not a cost at all. Not surprisingly, they fail to cite a single authority for this extreme assertion. As the Commission itself has explicitly noted, "the forward-looking cost of capital, *i.e.*, the cost of obtaining debt and equity financing, is one of the *forward-looking costs* of providing the network elements." *Local Competition Order* at 15854-55 ¶ 700 (emphasis added).

Second, AT&T cites two Supreme Court decisions observing that a public utility is generally entitled to a rate of return equal to that of other firms with "corresponding risks." AT&T AFR at 5 (citing *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n of W. Va.*, 262 U.S. 679, 690 (1923); *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 604-05 (1944)). But this does not legitimize AT&T's inconsistent assumptions. The question here is what type of firms have the "corresponding risks" of providing unbundled network elements — that is, the risks associated with being compelled to provide capital intensive components of its products or services to competitors priced according to TELRIC and subject to leases that are cancelable at will. Unlike the cases cited by AT&T, in which rates were not based on any measure of forward-looking costs, let alone a regime such as TELRIC, the firms with "corresponding risks" for TELRIC purposes necessarily operate in a competitive market of the type assumed by TELRIC, and are subject to the added risks inherent in the unbundling regime itself, not the monopoly market AT&T and WorldCom advocate.

Third, AT&T/WorldCom's cite to the "stand-alone cost" methodology used in the regulation of the railroad industry is similarly inapt. *See* AT&T AFR at 6 & n.2; WorldCom AFR at 5. As Dr Kahn has explained in previously refuting this same argument, there are at least two reasons why the risks created by TELRIC's assumption of a competitive market — that prices will be driven down based on the expectation that a firm will ubiquitously deploy the most

efficient, currently available technology — do not exist in the stand-alone cost approach as applied to the railroad industry. First, railroads have not experienced the technological progress found in the telecommunications industry, and so the risk created by TELRIC that prices will be driven down due to (assumed) technological progress does not exist.[9/] Second, stand-alone cost is generally used to estimate the cost of building facilities to serve a single route or group of shippers and therefore does not reflect any economies that would result from building an entire network.[10/] As a result, "stand-alone cost" is usually *higher* than the incumbent's actual forward-looking cost, and its application does not create the same regulatory risks as TELRIC. *See* Kahn, *How Not to Deregulate*, at 61-62 n.40

Finally, AT&T suggests that basing the cost of capital on the competitive market assumptions underlying TELRIC rather than solely on "actual competitive risks" is discriminatory because Verizon VA's own costs reflect only those actual risks. AT&T AFR at 5. As a threshold matter, AT&T is simply wrong because an appropriate cost of capital must take into account future competitive risks, such as growing wireless substitution and the rapid emergence of cable telephony and voice over IP service, as well as non-traditional means of communication such as e-mail and instant messaging.[11/] Moreover, even apart from this

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[9/] *See* Alfred E. Kahn, *Whom the Gods Would Destroy, or How Not to Deregulate*, AEI-Brookings Joint Center for Regulatory Studies, at 61-62 n.40 (2001) ("*How Not to Deregulate*") (contrasting the stand-alone cost methodology and TELRIC and noting that "there was no conception of the railroad industry's being subject to so rapidly improving a technology that a grounds-up TSLRIC for any group of customers would be *lower* than the actual long-run incremental costs of the railroads for that traffic").

[10/] *See, e.g., FMC Wyoming Corp. and FMC Corp. v. Union Pac. R.R., et al.*, STB Docket No. 42022, STB Ex Parte No. 346 (Sub-No. 29A), 2000 STB LEXIS 269, at *37 (May 10, 2000); *Potomac Elec. Power Co. v. ICC*, 744 F.2d 185, 189 (D.C. Cir. 1984).

[11/] *See, e.g.*, Lehman Brothers, *Telecom Services — Wireline: Earnings Preview*, at 3 (Oct. 10, 2003) (noting "fundamental shifts in Consumer behavior" that "continue to drive the

threshold flaw, AT&T still misses the point. As the Commission has repeatedly explained, "an appropriate cost of capital determination takes into account not only existing competitive [risks] . . . but also risks associated with the regulatory regime to which a firm is subject." FCC Reply Br. at 12 n.8. One of the regulatory risks Verizon VA faces under TELRIC is that its facilities are priced based on the assumption of a competitive market, and the cost of capital must reflect that risk. Indeed, *failing* to account for that risk in the cost of capital would discriminate *against* Verizon VA. As the Commission explained, "[t]o calculate rates based on an assumption of a forward-looking network that uses the most efficient technology (*i.e.*, the network that would be deployed in a competitive market), without also compensating for the risks associated with investment in such a network, would reduce artificially the value of the incumbent LEC network and send improper pricing signals to competitors." *Triennial Review Order* ¶ 682. And, as explained above, Verizon VA also faces the added risks inherent in the unbundling regime itself — risks that are in addition to those of a normal competitive market.

B. The *Order*'s Rejection of AT&T/WorldCom's Flawed Version of a Discounted Cash Flow Model and Inputs Is Fully Supported by the Record.

AT&T/WorldCom further challenge three specific decisions relating to the cost of capital adopted in the *Order*: its weighting of debt versus equity, its rejection of their preferred model

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deterioration in the RBOCs' access line base. Specifically, we believe wireless cannibalization and increasing broadband penetration will eat away at consumers' demand for traditional wireline services."); Niraj Gupta, Citigroup Smith Barney, *Cablevision Systems (CVC): Launches IP Telephony*, at 1 (Sept. 29, 2003) ("Cablevision launched IP telephony service late last week in Long Island and plans a rollout of service to its entire footprint by the middle of the [fourth quarter this year]"), UBS Investment Research Q Series, *Sayonara to Voice VOIP in Japan and the U.S.* (citing John Hodulik, UBS Investment Research, *Cable Telephony Competition: Who Gets It?*, at 1 (Aug. 7, 2003) (calling cable companies' rollout of cable telephony "the largest risk to Bell fundamentals over the next 5 years," and noting that "the impact on margins is increasingly evident today.")); F.J. Governali *et al.*, Goldman Sachs, *VoIP — The Enabler of Real Telecom Competition*, Ex. 3 at 1 (July 7, 2003) (noting that "VoIP is here now — it is not a far off event that can be overlooked," and observing that "[a]ll segments of the telecom industry . . . will feel the impact of VoIP as it gains more traction.").

for calculating the cost of equity, and its use of Verizon VA's proposed data for determining the market risk premium included in the cost of equity. In each case, however, AT&T/WorldCom's arguments are contrary to the record and should be rejected.[12/]

1. The *Order*'s Capital Structure Accurately Reflects the Conditions of a Competitive Market.

AT&T asserts that the *Order*'s adoption of a capital structure with 80% equity and 20% debt contains too much equity. AT&T AFR at 12. But AT&T/WorldCom's own estimate of a market-based capital structure was *identical* to that adopted in the *Order*. *See* Direct Testimony of John I. Hirshleifer at 38 (July 31, 2001) ("AT&T/WorldCom Ex. 5"). Furthermore, AT&T itself uses a market value capital structure containing **[BEGIN AT&T PROPRIETARY]** XXX XXXXXXXXXXX **[END AT&T PROPRIETARY]** to estimate its own cost of capital for use in investment decisions. AT&T Response to Staff Record Request No. 10 (Oct. 24, 2001). Likewise, the *Order*'s decision accords with Verizon VA's analysis, which showed that during each year between 1996 and 2000, the market-based capital structure for the S&P Industrials — which is made up of companies of average competitiveness — contained more than 85% equity, and the structure for telecommunications companies ranged from 78% to 85% equity.[13/] *See* VZ-

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[12/] AT&T also suggests that the *Order*'s cost of capital is too high because discount rate estimates prepared by financial analysts and that appeared in certain Verizon SEC filings are lower. *See* AT&T AFR at 3. But those estimates were for Verizon as a whole and are lower than the appropriate cost of capital for use specifically in connection with the provision of UNEs, since Verizon is involved in numerous businesses and diversifies its risks. *See* VZ-VA Ex. 118 at 35; Tr. at 3514. In any event, the discount rates referenced by AT&T were prepared specifically in the context of the Bell Atlantic/GTE merger, *see* Direct Testimony of John I. Hirshleifer at 44-47 (July 31, 2001) ("AT&T/WorldCom Ex. 5"), and, as Verizon VA witness Dr Vander Weide explained, the evidence demonstrates that the cited discount rates were lower than the market's actual estimate of even the merged company's cost of capital. *See* VZ-VA Ex. 112 at 67-68.

[13/] As AT&T notes, to be conservative, Verizon VA used a capital structure of 75% equity and 25% debt to calculate the cost of capital. *See* VZ-VA Ex. 104 at 44-45. But, given AT&T's

VA Ex. 104 at 44-45; *Order* ¶ 103. This same evidence — which shows consistent equity weightings of approximately 80% for both the S&P Industrials and telecommunications companies over a five-year period — refutes AT&T's assertion that the market weighting adopted in the *Order* reflects some undefined "short-run fluctuations." AT&T AFR at 12. Thus, AT&T does not offer a basis to reverse the *Order*'s market-based capital structure that accords with AT&T's own proposal in the arbitration.[14/]

2. The *Order* Properly Rejected AT&T's Proposed Three-Stage DCF Model for Calculating the Cost of Equity.

AT&T/WorldCom proposed that the cost of equity be based on a three-stage "discounted cash flow" ("DCF") model. The *Order* appropriately rejects that model both because it produces irrational results and because it is based on unsupported assumptions. The Commission should deny AT&T/WorldCom's attempt to resurrect their model.

The *Order* correctly concludes that AT&T/WorldCom's model "produces results that are inconsistent with expectations regarding the risks of different types of companies." *Order* ¶ 76. In particular, as Verizon VA showed, AT&T/WorldCom's proposed model produces the illogical result that *higher* risk companies have a *lower* cost of equity than lower risk companies. *See* VZ-VA Ex. 112 at 71-75; VZ-VA Ex. 118 at 43-44. Therefore, for example, AT&T/WorldCom's

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own proposal of an 80/20 market weighting, and Verizon VA's evidence showing that the market weightings over a 5-year period were generally above 80%, the *Order*'s adoption of an 80/20 weighting clearly was reasonable.

[14/] Although AT&T attempted to argue during the proceeding that the capital structure should be based in significant part on the incumbent's *book value* capital structure, even it no longer attempts to defend the book value approach, which looks to historical costs and is irrelevant under TELRIC *See Order* ¶ 102; *see also* Verizon Virginia Inc. Initial Post-Hearing Brief at 48 (Dec. 21, 2001) ("VZ-VA Initial Br."). Thus, while AT&T points in passing to incumbents' book value capital structures in 2000 as supposed evidence that the *Order*'s capital structure contains too much equity, AT&T AFR at 11, this reference to book value capital structures is beside the point.

three-stage DCF model results in electric and natural gas distribution companies having higher costs of equity than the S&P Industrials. Although AT&T asserts that Verizon's analysis of the AT&T/WorldCom model is incorrect, *see* AT&T AFR at 9, it identifies no specific error in that analysis. In fact, Verizon witness Dr. Vander Weide followed basic statistical principles and methods accepted throughout the financial community in showing that AT&T/WorldCom's model produces wholly illogical results, and AT&T provides no explanation for those results. *See* Verizon Virginia Inc. Post-Hearing Reply Brief at 39 (Jan. 31, 2002) ("VZ-VA Reply Br.").

The *Order* rejects AT&T/WorldCom's model for the additional reason that AT&T/WorldCom "offer[ed] no explanation or evidence supporting the magnitude or the pattern of the growth rate assumptions beyond the fifth year" in their model. *Order* ¶ 75. While AT&T disagrees with that finding, *see* AT&T AFR at 8-9, it offers no basis to reverse it. AT&T/WorldCom's model arbitrarily mixes and matches different assumed growth rates. They first assume that their proxy companies' earnings and dividends would grow in line with the dividend growth forecast issued by Value Line — an industry research firm — in year one; they then assume earnings and dividends would grow in line with earnings growth forecasts from another industry source — the Institutional Brokers' Estimate System ("I/B/E/S") — in years two through five. *See* AT&T/WorldCom Ex. 5 at 16. The CLECs' model next assumes that the proxy companies' earnings and dividends would decline over a period of fifteen years to an "expected" GNP growth rate of 6.29%, and then remain there permanently. *See id.* As Verizon VA explained, this patchwork of assumptions for different years is entirely arbitrary and simply self-serving. Indeed, the CLECs' approach ignores that it is common for companies to grow at rates much greater than that of the GNP for long periods of time and that the average I/B/E/S rate of growth is achievable for periods longer than the five years AT&T/WorldCom select. *See* VZ-

VA Ex. 112 at 44, VZ-VA Ex. 118 at 39. Furthermore, Dr. Vander Weide showed that the statistical correlation between the average growth rate in AT&T/WorldCom's three-stage DCF model and companies' price-to-earnings ratios is essentially *zero*, which shows that investors do not use AT&T/WorldCom's growth assumptions when they value companies' stocks. *See* VZ-VA Ex. 192. AT&T's claim that all cost of equity models have some degree of imprecision and uncertainty, *see* AT&T AFR at 8, cannot make up for the arbitrary nature of its growth assumptions.

Even though the *Order* correctly rejects AT&T/WorldCom's three-stage DCF model, it should have adopted Verizon VA's proposed one-stage DCF model rather than AT&T/WorldCom's CAPM model. As Verizon VA explained in its application for review, the *Order*'s adoption of the CAPM model was inappropriate because it is overly sensitive to fluctuating interest rates. *See* VZ-VA AFR at 49-50; *see also* VZ-VA Ex. 112 at 59-60. Even AT&T, the party that *proposed* the CAPM in this proceeding, now agrees that it "has not been, and cannot be, fully tested to determine 'whether it fits the facts.'" AT&T AFR at 8 n.4 (citing publications critical of the CAPM).

Contrary to AT&T's claim, it would have been far more appropriate for the Bureau to adopt Verizon VA's proposed one-stage DCF model because this produces the most reasonable estimate of a forward-looking cost of capital. As Verizon VA demonstrated, the single-stage DCF model with the I/B/E/S growth rates results in a highly significant correlation between growth rates and stock prices, indicating that this approach correlates with how investors value stocks. *See* VZ-VA Ex. 192. Moreover, unlike AT&T/WorldCom's three-stage model, Verizon VA's model produces the logical result that higher growth companies have higher price-to-earnings ratios than lower growth companies. *See id.* Thus, as the *Order* itself notes, the

"constant growth DCF model has been widely accepted by regulators for many years," and the Commission itself used this model to derive the 11.25% cost of capital it has stated should be the starting point for determining a TELRIC cost of capital. *Order* ¶ 73 n.224. AT&T again argues that Verizon VA's single-stage growth assumption wrongly assumes that a company will grow "at the same rate forever." AT&T AFR at 7. However, because the results of future periods are discounted in the DCF model, the assumed growth rate has an increasingly diminishing effect in future years, and a single-stage DCF model thus reasonably approximates how prices are determined in capital markets even if companies generally do not grow at the same rate "forever." VZ-VA Ex. 112 at 44-45. Thus, while the *Order* is right to reject AT&T/WorldCom's three-stage DCF model, it should have adopted Verizon VA's DCF model rather than the CAPM.

3. The *Order* Correctly Used Verizon VA's Recommended Data to Calculate the Market Risk Premium.

Although the *Order* errs in using the CAPM rather than Verizon VA's one-stage DCF model to calculate the cost of equity, it correctly adopts Verizon VA's approach to calculating the market risk premium for use in that model. In the CAPM, the market risk premium represents the difference between the expected rate of return for the market overall and the expected rate of return an investor could obtain if it faced no risk. *See Order* ¶ 81; VZ-VA Ex. 112 at 49. The *Order* appropriately relies on widely accepted, published data to determine this risk premium rather than AT&T/WorldCom's unexplained estimates.

When Verizon VA recalculated the cost of equity using the CAPM in response to AT&T's CAPM proposal, it relied on risk premium data from Ibbotson Associates — a firm that is a well-known and well-accepted source of such data — based on the average difference between the return on large company stocks and the yield on long-term Treasury bonds for the

period from 1926-1999 *See* VZ-VA Ex. 112 at 60. As the *Order* explained, "Ibbotson Associates publishes risk premiums that are widely used," and the time period from 1926 to 1999 (which was the most recent data available at the time the studies were performed) is widely accepted as the most reliable for use in a risk premium study. *Order* ¶¶ 83, 85; VZ-VA Ex. 112 at 54. Furthermore, as the *Order* notes, AT&T itself used Ibbotson Associates' risk premium data in one of its specifications for the CAPM model, and "AT&T has relied on the Ibbotson Associates' historical risk premium for government securities, either in whole or in part, in the CAPM analyses it has undertaken to estimate the cost of capital for evaluating real-world business projects." *Order* ¶ 83.

Despite all of this — and indeed despite having relied in part on historical data extending back to *1802* in its own CAPM calculations — AT&T now claims that the historical data used by Verizon VA and adopted by the *Order* is not an accurate indicator of expected returns going forward. *See* AT&T AFR at 10 But AT&T's arguments offer no basis to reverse the *Order*. First, while AT&T erroneously claims that Professor Ibbotson agreed in a 2002 article that the approach adopted by the *Order* overstates the risk premium, *id.*, the *2003* edition of the Ibbotson Yearbook continues to recommend the period 1926 to the present for estimating the future risk premium on equity and fully supports the arithmetic mean risk premium approach adopted by the *Order*.[15/]

[15/] *See* Ibbotson Associates, *Stocks, Bonds, Bills, and Inflation Valuation Edition 2003 Yearbook* at 71-80 (2003) ("*2003 Ibbotson Yearbook*"). In the article cited by AT&T, Professor Ibbotson was *not* discussing the appropriate risk premium to be used in the CAPM (or any other) model and instead was referring to the expected *geometric* mean of the return on stocks. That figure is irrelevant to the question here. As the *Order* explains, "most cost of capital experts agree that the arithmetic historical average, not the geometric historical average risk premium, should be used in the CAPM analysis." *Order* ¶ 84; VZ-VA Ex. 112 at 54-58; *2003 Ibbotson Yearbook* at 71-73. Similarly, AT&T's citation to a few select academic articles as purported

Second, AT&T's claim that the *Order* inappropriately rejects its so-called "forward-looking" risk premiums should be disregarded. The Bureau correctly determined that the Merrill Lynch expected rate of return relied upon by AT&T and WorldCom was unsupported, as AT&T and WorldCom provided no explanation of how Merrill Lynch arrived at its expected 10.20% rate of return. *See Order* ¶ 84. AT&T claims that its witness Mr. Hirshleifer "explained . . . how he validated the Merrill Lynch values through his *own* analysis *in previous UNE cases*." AT&T AFR at 11 (second emphasis added). But what Mr. Hirshleifer may or may not have done in *previous* UNE cases is not on the record here and is clearly irrelevant. And the *only* "explanation" Mr. Hirshleifer offered in *this* case was the one-sentence assertion that one of his estimates in 1999 was close to Merrill Lynch's expected return in 1999. AT&T/WorldCom Ex. 5 at 27-28. Thus, the *Order* is indisputably correct that AT&T did "not explain or document how Merrill Lynch derives this number." *Order* ¶ 84.

Finally, AT&T's related claim that Dr. Vander Weide somehow supported the Merrill Lynch rate of return estimate is simply untrue. *See* AT&T AFR at 11. As is obvious from Dr. Vander Weide's testimony, in response to Mr. Hirshleifer's claim that the Merrill Lynch estimate produced higher results than AT&T's three-stage DCF model, Dr. Vander Weide simply reran Mr. Hirshleifer's three-stage DCF model using June 2000 data for the S&P 500 and demonstrated that, contrary to Mr. Hirshleifer's claim, the three-stage DCF model produced a result higher than the Merrill Lynch estimate. *See* VZ-VA Ex. 112 at 52. In exposing the falsity

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support for its claim that the expected equity risk premium is lower than that produced by the 1926-1999 historical data is unavailing. *See* AT&T AFR at 10 n.8. AT&T never referred to these articles in the course of this proceeding, and there is no basis on the record to evaluate the assumptions underlying the papers' estimates of a risk premium and whether, for example, they are consistent with the assumptions used to calculate the remaining components of the cost of capital here.

of Mr. Hirshleifer's claim, Dr. Vander Weide never suggested he was *supporting* Mr. Hirshleifer's analysis or the use of the Merrill Lynch estimates.

II. THE COMMISSION SHOULD NOT RANDOMLY ADJUST BASIC LOOP COSTS TO ACCOUNT FOR AN ALLEGED OVERSTATEMENT OF STRUCTURE COSTS.

The modified version of the universal service model should not be used to set UNE loop rates. Proving this point, the CLECs now argue that because their own model cannot measure high capacity loop costs, the Commission should reduce the basic loop rates by a random amount to account for phantom shared outside plant structure costs by simply assuming that the high capacity loop rates recover some share of structure costs. But that makes no sense, and would result in certain underrecovery of Verizon VA's structure costs. In fact, reducing the loop rates by *any* amount would make no sense, because, as Verizon VA has shown, those rates already understate Verizon VA's costs. Instead, the Commission should reject the *Order*'s use of the modified universal service model for loop costs entirely, as well as the *Order*'s entirely non-cost based high capacity loop rates, and adopt Verizon VA's models, which properly account for the costs of both basic and high capacity loops, and allocate the proper share of shared structure cost to each. The Commission has recognized repeatedly that the universal service cost model should not be used to set UNE rates, and AT&T/WorldCom's arguments demonstrate why the Commission's prior decisions were right

A. The *Order*'s Rejection of AT&T/WorldCom's Inflation of the 2-Wire Loop Count and Understatement of 2-Wire Loop Costs Is Entirely Correct.

AT&T/WorldCom complain here that the *Order* overstates the shared structure costs to be included in the 2-wire loop rates by rejecting the CLECs' proposed treatment of high capacity loops in the modified universal service 2-wire loop model. Specifically, the Bureau rejected the CLECs' proposal to base 2-wire loop rates on a vastly inflated loop count that treated high

capacity loops as if they were individual 2-wire loops. The universal service model counts every DS-1 as though it were 24 basic 2-wire (DS-0) loops (because it has 24 times the channel capacity of a DS-0), and every DS-3 as though it were 672 basic 2-wire loops (because it has 672 times the channel capacity of a DS-0).[16] *See Order* ¶ 203; AT&T AFR at 14; WorldCom AFR at 7.

As a result, the CLECs' model substantially overstated the number of 2-wire loops. This decreased the average unit cost of the basic 2-wire loop because the total cost of basic, 2-wire loops was spread across this inflated number of loops.[17]

The *Order* correctly rejected this approach as entirely nonsensical and unfair. As the Bureau noted, AT&T/WorldCom's proposed method of setting 2-wire loop rates and high capacity loop rates would necessarily result in "under-recovery of total outside plant costs." *Order* ¶ 208. In particular, AT&T/WorldCom's approach "creates total cost and cost allocation problems that all but ensure that total outside plant costs are not recovered." *Id.* And the Bureau dismissed an adjustment AT&T/WorldCom made to try to rectify the problem caused by the overstatement of the number of lines (inflating some of the copper investment cost allocated to the 2-wire loops). *See id.* ¶ 209 (finding no "evidence that the overstatement of costs offsets the overstatement of the DS-0 equivalent line count. Rather, this 'two-wrongs-make-a-right' approach does not resolve the total cost problem (except, perhaps, by happenstance).") The

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[16] At the same time, AT&T/WorldCom then propose (and the Bureau agreed) to set high capacity loop rates on the assumption that DS-1 rates should be 4.3 times the DS-0 rate, and DS-3 rates should be 41.3 times the DS-0 rate — far lower than the 24:1 and 672:1 ratios the CLECs used to inflate the 2-wire loop count. *See Order* ¶ 203; AT&T AFR at 14.

[17] Verizon Virginia Rebuttal Testimony of Francis J. Murphy at 32-35 (Aug. 27, 2001) ("VZ-VA Ex. 109"); Verizon Virginia Rebuttal Testimony of Dr. Timothy Tardiff at 27-29 (Aug. 27, 2001) ("VZ-VA Ex. 108")

Bureau accordingly ordered that, for purposes of determining the basic 2-wire loop rates, the number of special access lines (which include the DS-1s and DS-3s) in each wire center in the model should be set to zero, or "zeroed out."[18/] *Id.* ¶ 211.

While the more appropriate response would have been for the *Order* instead to adopt Verizon VA's loop cost models to set all loop rates, the *Order*'s rejection of AT&T/WorldCom's inclusion of high capacity loops in the 2-wire loop cost study was correct. Even AT&T/WorldCom, who confine their argument to one narrow issue, are not seriously challenging the Bureau's overall determination in that regard. Instead, they argue that zeroing out the high capacity loop counts is wrong because it allocates *all* shared structure costs to the basic loops, and that this violates TELRIC principles by failing to properly allocate some costs to high capacity loops. *See* AT&T AFR at 13, 15; *see also* WorldCom AFR at 7-8.

AT&T/WorldCom are simply complaining about a shortcoming in the model they themselves advocated, and their argument demonstrates why the Bureau should not have used the CLECs' model to set loop rates in the first place. Because the CLECs' model is incapable of modeling high capacity loop costs, it cannot model the sharing of facilities *between* those loops and basic 2-wire loops. Indeed, the Bureau speculated about whether there were means of using the CLECs' model to try to produce the necessary data, but concluded that the CLECs had

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[18/] AT&T suggests that it was required to use the approach it did because Verizon VA failed to provide complete discovery responses concerning its non-switched loop count. *See* AT&T AFR at 14, 17. This is both false and irrelevant. Verizon VA provided AT&T with evidence concerning its narrowband and special access line counts. *See e.g.*, VZ-VA Responses to Follow Up Questions from AT&T/WCom to Verizon Re: Verizon's Responses to AT&T Sets 4 & 5 (discussing line counts, explaining how AT&T could calculate DS-0 equivalents, and identifying lines reported on a physical pair basis). AT&T's suggestion that this data excluded private lines is wrong and nonsensical. But in any event, as the Bureau specifically ruled, the high capacity DS-1 and DS-3 lines and a DS-0 equivalent count of such lines were not relevant to computing basic loop costs in the first instance. As Verizon VA witness Mr. Gansert explained at the hearing, those lines have "no influence on the narrowband cost." Tr. at 4520 (Gansert).

suggested no way "to effectuate such reasonable allocations of common costs among different loop types." *Order* ¶ 212 n.559.

And while AT&T/WorldCom may believe that inflating the number of loops somehow solved that problem by slashing the costs of the 2-wire loop, the Bureau disagreed, finding that AT&T/WorldCom's DS-0 equivalents methodology radically *understated* loop costs. *Id.* ¶ 208. It would have been plain error to approve a methodology that the Bureau acknowledged would "all but *ensure* that total outside plant costs are not recovered." *Id.* (emphasis added). The *Order*'s decision to zero out the high capacity loop rates at least offers some type of solution to the inherent underrecovery of the CLECs' model. *Id.* ¶ 210. Having advocated a model that cannot perform the tasks at hand, AT&T/WorldCom should not now be heard to argue about adjustments that are required precisely because their model is insufficient.

In any event, of course, the loop rates produced by the CLECs' model, even as adjusted by the Bureau, cannot overallocate structure costs to basic loop rates because the model substantially understates loop costs. If anything, then, the model likely understates the structure costs that properly should be allocated to basic loops. But even leaving that aside, the putative allocation concerns raised by AT&T/WorldCom is at best greatly overstated. By AT&T/WorldCom's estimate, there are only about 77,000 DS-1 and 6,000 DS-3 loops, as compared to almost 4 million basic switched loops in Virginia. *See* AT&T AFR Ex. 3. The opportunities to share structure accordingly are quite limited: Verizon VA can share structure only when a high capacity loop and a basic loop share the same route and use the same type of structure, and there is no reason to assume that this would occur with any frequency. To begin with, DS-3s almost *never* share the costs of structure investment allocated to copper distribution, because they always are served exclusively on fiber (which rarely coincides with the ordinary

loop distribution routes), and DS-1s are served on copper distribution only some of the time. And neither DS-1s *nor* DS-3s would normally share copper *feeder* structure costs, because they are assumed to be served on fiber feeder in the forward-looking network. More generally, since, as noted, sharing can take place only where the relevant loops follow the same precise route, the share of structure costs that might ever be borne by high capacity loops would account for only an insignificant share of the overall costs.[19/]

Finally, of course, none of these problems would have arisen had the *Order* adopted Verizon VA's loop and high capacity models. Unlike the CLECs' model, Verizon VA's models are capable of accurately measuring both basic *and* high capacity loop costs, and of allocating to each type of loop a proper share of any joint facilities by, among other things, explicitly accounting for the sharing of support structures by multiple cables. First, Verizon VA's cost models account for the fact that multiple cables often share the same poles. For example, in the case of aerial facilities, Verizon VA accounts for such sharing through a "multiple sheath factor," which allocates only a portion of the cost of each pole to a single cable. Tr. at 4536 (Sanford). For underground cables, Verizon VA's cost studies allocate to each cable the cost of only a single duct and then apply a utilization factor to account for a share of the cost of spare ducts.

Thus, the Bureau's concern about proper cost allocation using AT&T/WorldCom's model (as well as its recognition that the CLECs' proposal seriously understated loop costs) should have resulted in the adoption of Verizon VA's models. This also would have been far

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19/ Even AT&T/WorldCom's own erroneous analysis demonstrates that their argument that the current rates are unfair because they seriously overstate basic loop costs is overblown. Their proposed adjustment reduces the investment per loop by $23. AT&T AFR Ex. 3. This is only about 4% of the total investment per loop produced by the modified universal service model.

more consistent with the Commission's repeated recognition that "the USF cost model should not be relied upon to set rates for UNEs."[20/] As the Commission has explained:

> [There is a] critical difference between using the Synthesis Model (or any other model) to determine absolute UNE costs, and using it for the limited purpose of comparing relative cost differences between the states. In section 271 proceedings, the Commission uses the Synthesis Model only for the latter purpose; we have not used the model to compare UNE rates set by a state commission to costs produced by the model. Indeed, the Commission has repeatedly cautioned against using the Synthesis Model to set rates.[21/]

The Commission recently reiterated this point in the *TELRIC NPRM*, explaining that it did not intend for the universal service model "to provide *any* systematic guidance to states in the area of TELRIC rate-setting." *TELRIC NPRM* ¶ 46 (emphasis added). Accordingly, rather than adopting the modified universal service model and then trying to account for its inherent shortcomings, the Bureau should have adopted Verizon VA's models.

B. The *Order*'s High Capacity Loop Rates Do Not Overrecover Verizon's Structure Costs.

AT&T/WorldCom next claim that "the Bureau's approach guarantees . . . that Verizon will overrecover the costs of its joint facilities," because shared structure costs are included in both the 2-wire loop rates and somehow in the high capacity DS-1 and DS-3 loop rates as well.

[20/] Memorandum Opinion and Order, *Joint Application by SBC Communications Inc., Southwestern Bell Telephone Company, and Southwestern Bell Communications Services, Inc. d/b/a Southwestern Bell Long Distance for Provision of In-Region, InterLATA Services in Kansas and Oklahoma*, 16 FCC Rcd 6237, 6277-78 ¶ 84 (2001) ("*Kansas/Oklahoma 271 Order*"); *see also* VZ-VA AFR at 36-37 & n.46 (citing cases).

[21/] Memorandum Opinion and Order, *Application by Verizon Maryland Inc., Verizon Washington, D.C. Inc., Verizon West Virginia Inc., Bell Atlantic Communications, Inc. (d/b/a Verizon Long Distance), NYNEX Long Distance Company (d/b/a Verizon Enterprise Solutions), Verizon Global Networks Inc., and Verizon Select Services Inc., for Authorization to Provide In-Region, InterLATA Services in Maryland, Washington, D.C., and West Virginia*, 18 FCC Rcd 5212, 5265-66 ¶ 89 (2003) ("*Maryland/Washington, D.C./West Virginia 271 Order*").

AT&T AFR at 16. But the high capacity loop rates set by the Bureau are not set based on *any* measure of costs, and thus there is no basis to assume that they "recover" some allocation of structure costs. Indeed, neither AT&T/WorldCom nor the Bureau ever specified which investment costs for what categories of facilities or plant the DS-1 and DS-3 rates were designed to recover. Instead, as explained in Verizon VA's application for review, the Bureau rejected Verizon VA's high capacity loop cost studies in favor of using rate ratios proposed by AT&T/WorldCom without *any* cost justification whatsoever. *See* VZ-VA AFR at 39-42.

Specifically, AT&T/WorldCom proposed, and the Bureau set, DS-1 and DS-3 rates based on nothing more than made-up ratios, setting the DS-1 rate at 4.3 times the 2-wire loop rate, and the DS-3 rate at 41.3 times the 2-wire loop rate. *See Order* ¶¶ 338, 341. The Bureau itself admitted that it did not know how AT&T/WorldCom had derived these ratios. *See id.* ¶ 341 ("[W]e are troubled by the lack of thoroughness and clarity in AT&T/WorldCom's analysis[.]"); *id* ¶ 341 n.888 ("We have been unable . . . to identify the starting point for the AT&T/WorldCom calculations."). What is certain, however, is that neither AT&T/WorldCom nor the Bureau conducted any study of high capacity loop costs, or itemized the different cost categories that would be included in the high capacity loop rates.

Thus, AT&T's assertion that the high capacity loop rates are designed to recover some portion of shared facilities costs is made up out of whole cloth. It is unclear *what specific* costs produced by the *basic loop* model should be recovered by the *high capacity* loop rates, which are *not* produced by the model. Indeed, the only thing that is certain is that the high capacity loop rates are set too low to recover *any* fair measure of the costs of providing those loops. *See* VZ-VA AFR at 39-42. Notably, AT&T/WorldCom cannot point to any specific measure of structure costs within the DS-1 and DS-3 loop rates. Instead, in their applications for review, they for the

first time suggest that the measure of structure costs that should be *assumed* to be allocated to high capacity loops can be determined by resorting to the structure costs the modified universal model produces for ordinary loops; they assert that a portion of that total cost is somehow in the DS-1 and DS-3 rates. But that is impossible, given that their model *cannot* and *does not* produce the high capacity loop costs or rates; as AT&T/WorldCom's own witness conceded, "There is no question that [DS-1 and DS-3] services are not explicitly modeled in the network." Tr. at 4485 (AT&T/WorldCom witness Pitkin).

And AT&T/WorldCom's proposed means of determining how to reduce basic loop rates to account for the share of structure costs they claim is somehow embedded within the DS-1 and DS-3 loop rates makes no sense. They propose spreading all structure costs produced by the modified universal service model across a new loop count consisting of basic loops plus high capacity loops, this time treated as DS-0 equivalents based on the 4.3:1 and 41.3:1 ratios that were used to set the DS-1 and DS-3 loop rates. By inflating the line count in this way, AT&T/WorldCom are able to deflate the structure cost per line from $136.20 to $112.73 per line. AT&T AFR at 18.

AT&T/WorldCom are wrong for two reasons. First, they never made their proposal on the record. Indeed, the Bureau specifically noted, "we have no record on how to effectuate such reasonable allocations of [joint] costs among different loop types, [and thus] we have *no basis to implement such a solution in this proceeding*." *Order* ¶ 212 n.559 (emphasis added). Second, AT&T/WorldCom's new approach moves structure costs to the high capacity loops on the assumption that each DS-1 essentially takes 4.3 times the structure cost allocated to a 2-wire loop, and that each DS-3 takes 41.3 times the structure cost allocated to the 2-wire loop. As noted, the assumed 4.3:1 DS-1 to DS-0 and 41.3:1 DS-3 to DS-0 cost relationship is unsupported

and nonsensical. *See* VZ-VA AFR at 39-40. But even if those ratios reasonably reflect the relative *overall* costs of providing those types of loops, the ratios say *nothing* about the relative portion of *structure costs* that should be allocated to those types of loops.

Even if, for example, a DS-3 loop *did* cost on average 41.3 times more than a 2-wire loop, *every* type of cost associated with the DS-3 loop would *not* be 41.3 times higher than the corresponding cost for a 2-wire loop. As Verizon VA explained in its application for review, some 2-wire loop costs — *e.g.*, those associated with copper — might not be present *at all* in connection with a DS-3 loop; others, like the costs of the electronics used to serve DS-3s, are not used at all in connection with 2-wire loops. It thus is highly likely that the cost for a DS-3 includes significantly less than 41.3 times more *structure cost* than the 2-wire loop. Whatever that amount is, however, cannot be ascertained from the modified universal service model.

To take a simplified example: assume that two homes share a driveway, and home A costs 10 times more than home B. The fact that home A is 10 times more expensive than home B tells us nothing about how much of the cost of the shared driveway is included in the cost of each house Home A may be 10 times more expensive because it uses more expensive fixtures, is substantially larger, and has a pool and a better view than home B — factors that would have nothing to do with how much of the driveway the two homes use. In fact, the most appropriate allocation might be a 50/50 split, based on nothing more than the number of houses using the driveway. What is clear, however, is that there is simply no way to derive the correct answer from the relationship of the *total costs* of the two homes.

AT&T/WorldCom's proposal should therefore be rejected. The only appropriate means to allocate joint costs between basic and high capacity loop rates is to adopt Verizon VA's

models, which do precisely that. Short of that, the Commission should reject the CLECs' arguments and leave the Bureau's adjustment in place.

III. THE COMMISSION SHOULD NOT REDUCE LOOP RATES BASED ON THE TRIENNIAL REVIEW ORDER.

Finally, AT&T erroneously argues that the Commission's decision in the *Triennial Review Order* to relieve incumbent LECs of "unbundling requirements for the next-generation network capabilities of their hybrid loops," *Triennial Review Order* ¶ 286, should result in lower loop rates for CLECs because the "forward-looking economic cost of narrowband loop capacity is less than the forward-looking cost of loops that have not been stripped of their broadband functionality." AT&T AFR at 20. AT&T also argues that the risk associated with providing narrowband-only capacity is somehow lower than the risk of providing the loop with broadband capacity (notwithstanding the tremendous sunk investment associated with just the *basic* loop facilities). For these reasons, AT&T claims that the loop rates ordered by the Bureau "are almost certainly excessive" and must be adjusted by some unspecified amount. *Id.* at 21.

First and foremost, the loop rates set by the Bureau are not based on *any* costs relating to broadband, packetized service: neither model proposed by the parties even accounted for such costs in the loop rates. Thus, while AT&T insists that the "loop rates set by the Bureau are almost certainly excessive in relation to the limited functionality that Verizon must now provide," *id.*, AT&T points to no broadband-related costs that are somehow included in the *Order*'s loop rates. Indeed, AT&T is unable even to point to any specific broadband-related costs that allegedly should be eliminated and thus makes no specific proposal at all. This is because the basic loop rates adopted by the Bureau are based on AT&T's own modified universal service model, which, like the Commission's underlying Synthesis Model, is designed to develop costs *only* for narrowband services offered on 2-wire basic loops. The CLECs' model

includes only two types of loops, copper loops, and loops with copper distribution and fiber feeder, which are assumed to use the narrowband electronics accounted for by the model's DLC inputs. It is not designed to model costs for broadband services, including the electronic and other equipment used to transmit packetized information on hybrid loops. Thus, the model's investment costs and the related expenses already are limited to loops "stripped of their broadband functionality." *Id.* at 20. And Verizon VA's model similarly includes no broadband or packetized costs. There is thus no basis at all for AT&T's assertion that "broadband functionality" costs must be removed from the loop rates. Since the model was designed and proposed by AT&T itself, and since the Bureau adopted virtually every input advocated by AT&T, AT&T should not now be heard to claim that the inputs should have been adjusted.[22/]

Second, AT&T's argument not only is irrelevant to this case; it also presupposes an answer to the very question the Commission has just asked in the *TELRIC NPRM*. The *NPRM* specifically asks parties to consider "[w]hat implications . . . this [*Triennial Review Order*'s hybrid loop unbundling] limitation [has] for a pricing methodology based on forward-looking costs[.]" *TELRIC NPRM* ¶ 43. As noted above, the means by which *all* parties measure loop costs illustrate that there is no reason loop rates should change at all. But even if that issue required further exploration, AT&T itself recognizes that this is not the proceeding in which any discussion of changes to the pricing rules should take place. Indeed, just days ago, AT&T presented an ex parte to the Commission in the *TELRIC* proceeding arguing this very issue, and proposed that unbundling decisions made in the *Triennial Review Order* require "the

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[22/] Similarly, the cost of capital adopted by the *Order* — and the cost of capital inputs proposed by both parties — were not set on a UNE-specific or service-specific basis, so AT&T's suggestion that the loop rates should now be specifically "adjusted" to reflect narrowband-specific risk makes no sense at all, nor does AT&T even try to suggest how this could be done.

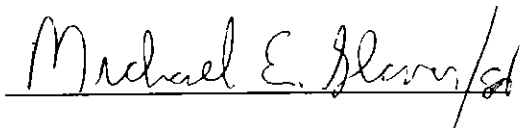
development of a methodology to reduce current TELRIC-based prices to reflect the diminished cost and value of TRO-compliant UNEs."[23/] As noted above, that argument is simply wrong. But in any event, AT&T's suggestion here that the Commission should quietly decide this issue in this restricted proceeding — and inconsistently with the record, at that — is entirely inappropriate.

[23/] Letter from Joan Marsh, Director, Federal Government Affairs, AT&T, to Marlene Dortch, Secretary, FCC, *In the Matter of Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers*, WC Docket No. 03-173, at 4 (Oct. 8, 2003).

CONCLUSION

For the reasons stated above, the Commission should deny AT&T/WorldCom's applications for review.

Submitted by,



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